

**Report Submitted to the United States  
Agency for International Development**

**USAID/El Salvador**  
**Assessment to Identify Legal/Regulatory  
Obstacles to the Full Implementation  
of CAFTA within El Salvador**

**Final Report**

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## Acronyms

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ANEP	National Association of Private Enterprise
ARENA/PCN	<i>Alianza Republicana Nacionalista/Partido de Conciliación Nacional</i>
CACM	Central American Common Market
CAFTA	Central American Free Trade Agreement
CD	compact disc
CEPA	Salvadoran port authority
CNJ	<i>Consejo Nacional de la Judicatura</i>
COEXPORT	<i>Corporación de Exportadores de El Salvador</i>
FTAA	Free Trade Area of the Americas
FUSADES	Salvadoran Foundation for Economic and Social Development
IDB	Inter-American Development Bank
ILO	International Labor Organization
IPR	Intellectual property rights
MIF	Multilateral Investment Fund (IDB)
NAFTA	North Atlantic Free Trade Agreement
OAT	Office of the Administration of Treaties
PGR	<i>Procuraduría General de la República</i>
PNC	<i>Policía Nacional Civil</i>
PROESA	El Salvador's investment promotion office
SIGET	Superintendency of Electricity and Telecommunications
TRIMs	Trade-Related Investment Measures
TRIPs	Trade-Related Aspects of Intellectual Property Rights
UACI	<i>Unidad de Adquisiciones y Contrataciones Institucional</i>
UNAC	<i>Unidad Normativa de Adquisiciones u Contrataciones de la Administración Pública</i>
UTE	<i>Unidad Técnica de Evaluación</i>
WTO	World Trade Organization

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## 1.0 Introduction

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1. The objective of this assessment is to identify legal and regulatory obstacles in the implementation of laws in El Salvador affecting the private sector engaged in trade and investment, or acting as impediments to foreign investment. Recommendations regarding possible interventions distinguish between those that can be activated prior to the July 2005 rule of law component of the current USAID/El Salvador strategy, and those that will require a longer-term commitment.
2. This analysis focuses on issues and recommendations that will contribute to taking full advantage of the Central American Free Trade Agreement (CAFTA) and its objectives, including the economic development of El Salvador. Areas within the legal system that need further reform and strengthening have been identified. Interviews with an extensive number of executives from private sector associations, law firms, and private national and foreign companies revealed serious obstacles in important economic sectors that will greatly hamper El Salvador's full realization of the benefits from new opportunities offered by CAFTA. These areas are briefly discussed in Appendix I.
3. A total of 12 potential legal and regulatory projects have been identified where reform would lead to an improved environment for private national and foreign companies and/or full implementation of CAFTA. The proposed projects are classified in three categories:
  1. *High-Priority, Near-Term Recommendations* (Section 2.0):
    - Reform of the administration of justice,
    - Technical assistance for new arbitration centers,
    - Ratification of International Labor Organization (ILO) agreements on labor laws,
    - Reform of the Agency Law, and
    - Technical assistance for the Office of Administration of Treaties.
  2. *High-Priority, Longer-Term Recommendations* (Section 3.0):
    - Harmonization of laws and regulations within the Central American Common Market (CACM),
    - A new anti-monopoly law,
    - More flexible work rules in the Labor Code, and
    - Compliance of tax incentives with World Trade Organization (WTO) rules.
  3. *Lower-Priority, Longer-Term Recommendations* (Section 4.0):
    - Strengthening enforcement of intellectual property rights (IPR) legislation,
    - Broadening the new Government Procurement Law, and
    - Enforcing national treatment laws applicable to small foreign investors in some service sectors.
4. Programs in the justice areas that are currently being funded by donor agencies are listed and described in Appendix II.
5. This USAID project (Contract No. AEP1-00-99-00041-00) was awarded to ARD, Inc. by the USAID Democracy and Governance Office in El Salvador. It was carried out in February and April 2003 by Siegfried Marks (Team Leader) of Sigmar International (Miami) and Luis Alonso Medina, Benjamin Valdez Iraheta, and Gualtiero Carrillo Almanni of the Rusconi-Valdez & Asociados law firm (San Salvador).

## 1.1 Laws and Regulations

6. In wide-ranging discussions about El Salvador's justice system, assessment participants such as lawyers, justices, government officials, law professors, business leaders, labor leaders, exporters, and foreign investors emphasized that the Constitution and most laws are not an impediment to trade and investment. There is room for improvement, however. There is no anti-monopoly law and some laws need revisions to better support national economic policy objectives.
7. Laws and regulations have been improved in many areas by the government and the Assembly in recent years, including environmental and IPR protection legislation, a new Government Procurement Law, and an Arbitration Law. More reform is intended, such as the planned revision of the omnibus Commercial Code.

## 1.2 Institutions

8. Some institutions have been strengthened and new ones have been created to make the regulatory environment more effective for the private sector. The National Office for Investments was created to serve as a “one-stop shop” for investors to facilitate and accelerate the process for setting up a new investment. PROESA, El Salvador's investment promotion office, is designed to promote private investments. A second export promotion agency is being planned. The Office of the Administration of Treaties (OAT) operates to administer the rules of origin and duty rate determination according to the terms agreed upon under regional free trade agreements. A new law<sup>1</sup> promotes the establishment of privately operated arbitration centers aimed at greatly improving the dispute arbitration process.
9. Private sector organizations have actively participated in developing reforms in many areas. ANEP, the National Association of Private Enterprise, for example, has developed and presented to the government a comprehensive outline of private sector “best practice” principles and recommendations for national policy objectives. FUSADES, the private Salvadoran Foundation for Economic and Social Development, has, among other studies, developed policy analyses and recommendations relating to CAFTA.
10. There are still weaknesses that need to be resolved in some of the regulatory entities for more effective functioning and proper enforcement of their decisions, such as the case of SIGET, the Superintendency of Electricity and Telecommunications.

## 1.3 The Application of Justice

11. The main problem resides with the justice system in the implementation, application, and enforcement of laws; observance of legal procedures; capability of justices and judges; speedy and fair resolution of court cases; and enforcement of punitive decisions. Poor application of justice weakens the positive effects of good commercial laws on the functioning of the business environment.

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<sup>1</sup> *Ley de Mediación, Conciliación y Arbitraje*: Legislative Decree Number 914 of July 11, 2002. Published in the Official Gazette No. 153 of August 21, 2002.

## Obstacles to Trade and Investment in El Salvador and Recommended Projects to Address Them

Obstacles		Recommendations	
High-Priority, Near-Term Projects			
High degree of uncertainty in judicial decisions		Review and analyze the identified weaknesses and gaps in the commercial justice system and develop longer-term programs in the four problem areas (judicial training and appointment, Supreme Court/CNJ role definition, and the application of justice).	
Need for structural and enforcement guidelines for newly established or proposed dispute settlement/arbitration centers.		Establish clear guidelines for the effective functioning of the arbitration centers and for the speedy enforcement of decisions and awards.	
El Salvador never ratified signed ILO agreements to establish and implement laws governing labor union formation and collective bargaining.		Prepare proposals for a new law or reform of existing labor legislation containing the elements originally negotiated with the ILO plus provisions strengthening the enforcement of the new legislation on the freedom to form unions as well as collective bargaining.	
Excessive indemnity payments under the Agency Law to agents or distributors whose contracts lapse or are terminated.		Develop options for a more equitable approach, including the removal of this provision in a revised Commercial Code or calculation of indemnity payments on the basis of net profits or limiting payments or eligibility	
The Office of the Administration of Treaties (OAT) has little experience in monitoring rules of origin and could present problems for complying with the terms of CAFTA.		Develop an effective training program for employees of the OAT in monitoring, testing, and enforcing compliance with the rules of origin that will govern CAFTA.	
High-Priority, Longer-Term Projects			
Harmonization of laws, regulations, and their application have not advanced enough in the CACM to avoid problems to fully implement CAFTA.		Promote public-private sector working groups to analyze regulatory and institutional diversities and develop programs for harmonization throughout Central America.	
The absence of an anti-monopoly law encourages monopolistic practices and other non-competitive behavior, and the Salvadoran government lacks the political will to propose and pass such legislation.		Review past anti-monopoly bills and revive and support the one that best protects against monopolistic abuses.	
Regulations in the Labor Code are considered too inflexible by the private sector.		Review the Labor Code and propose more flexible provisions for attracting investments in labor-intensive service sectors.	
Tax incentives for companies in Free Trade Zones are considered in violation of WTO rules.		Preferably together with other Central American and Caribbean countries, develop legal entities and strategies for ameliorating or overcoming the double-negative effects of WTO noncompliance and termination of the Multi-Fiber Agreement on El Salvador's and Central America's <i>maquiladora</i> sector.	
Lower-Priority, Longer-Term Projects			
Lax enforcement of IPR laws.		Continue work on proposals for programs for active monitoring and improved enforcement of compliance with and prosecution of IPR laws.	
New Government Procurement Law restricts "emergency" tenders with inadequate prior notice and excludes bids and concessions for natural resource exploitation or existing infrastructure projects.		Eliminate abuse of "emergency" tenders and explicitly extend the rules for transparent, non-discriminatory, national treatment of bidders to concessions for natural resource and all infrastructure development.	
The Constitution and Investment Law reserve certain economic sectors for national micro and small enterprises, but these provisions are not enforced.		Develop a proposal for legislation aimed at unequivocally extending national treatment to all foreign investors in conformance with international standards and obligations.	



## 2.0 High-priority, Near-Term Recommendations

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### 2.1 Reforming the Administration of Justice

12. **The Problem: A high degree of uncertainty in judicial decisions.**
13. The commercial legal environment is currently negatively affected by a pervasive uncertainty about the application of justice, and particularly about the outcome of judicial decisions. All national and foreign investors and lawyers interviewed expressed strong doubts that the rule of law is being fairly observed in all court cases, including Supreme Court decisions. Interviewees even noted the widespread miscarriage of justice. In the famous McDonald's case, all the different levels of court—including the Supreme Court—ruled that the foreign company had proved to the satisfaction of the court that its cancellation of the contract with its distributor was justified. Yet, after years of proceedings and judgments, the case is continually being reopened while the contract-violating distributor remains in business, still using McDonald's intellectual property. While this is an extreme case, private sector contacts insist that the poor administration of justice is quite commonplace.
14. There is little confidence by investors that disputes will be settled fairly and expeditiously in the courts. Long delays are common before a final judgment is reached. Creative evasion enables enforcement of a decision to be delayed or avoided altogether. The laxness in the application of commercial laws and the inability to achieve fair and expeditious dispute resolution affects the business environment negatively. Companies can face substantial business losses if the courts do not enforce contract terms.
15. The gap between good laws and poor implementation, application, and enforcement can also affect the full and prompt compliance with all the agreed terms and conditions of a future CAFTA. The problems cited by the legal and business community revolve around the low capability of judges and justices, a slow process of dealing with court cases and arriving at final decisions, lack of accountability or observance of court procedures by judges, political influence on court decisions, lack of enforcement of compliance with laws, failure to observe legal procedures or to accept evidence, disregard for legal precedence, and no oversight that judges properly observe the laws.
16. The four most pressing problem areas include:
  - judicial training and education,
  - the judicial appointment process,
  - role definition for the Supreme Court and *Consejo Nacional de la Judicatura* (CNJ), and
  - the practical application of justice.
17. The problems start with the education and preparation of judges, because they often demonstrate a lack of proper understanding of commercial law. Businessmen complain that judges or justices often apply general principles of law to specific and substantive disputes requiring the application of commercial law. The resulting court decisions are deemed to be unsatisfactory or outright unfair.
18. The second problem relates to the selection and appointment process of justices and judges. Graduates from law school are not ranked according to their final standing in their class upon graduation, so this benchmark is not available for the selection process. The CNJ and the lawyers' associations each propose an equal number of candidates to fill vacancies at the Supreme Court. The Assembly then votes to make the final decision. In this way, it is not the CNJ alone that

proposes candidates for the Supreme Court. With respect to lower court judges such as those of the appeals court, first instances judges, and Justices of the Peace, the CNJ alone is in charge of selecting new candidates from which the Supreme Court then makes the appointments.

19. There is widespread dissatisfaction with both processes. The CNJ has not revealed how they select their candidates for the Supreme Court. Only when choosing candidates for lower court judges do they apply a transparent selection method. The various lawyers' or bar associations each propose candidates for Supreme Court justices by engaging in "horse trading" operations. Candidate selection is often not based on merit. Informed legal sources indicate that the selection process should be more transparent and less politically motivated. The CNJ president defends its selection process by pointing out that it results in the selection of the best available candidates.
20. The third problem consists of a turf battle between the Supreme Court and the CNJ, with each trying to expand its areas of responsibility at the expense of the other. The Supreme Court would like to have more influence over the CNJ's selection of candidates for judges. The CNJ wants full jurisdiction over the entire evaluation process of judges, as well as other administrative functions related to promotions, transfers, and dismissal of judges. These duties are currently exercised by the Supreme Court, which the CNJ argues is in violation of the law. It is argued that the Supreme Court spends an inordinate amount of time on sometimes minor administrative functions, while major court cases requiring the interpretation of the Constitution pile up unresolved.
21. The fourth problem resides in the at-times poor application of justice. Judges are free to dismiss vital evidence and witnesses or to pass judgment on the basis of only one witness. They can and do ignore relevant case precedence. Political pressures on judges sometimes cause them to dismiss or delay cases or to influence their final outcome. Some cases are even reopened after a final decision has been reached by judges.
22. **The Recommendation: A high-priority, near-term project to review and analyze, in-depth, the identified weaknesses and gaps in the justice system and then develop longer-term programs in the four problem areas outlined above for the removal of specific barriers to a sound administration of commercial laws.**
23. The responses from the private sector in the discussions held during the preparation of this report clearly identified the four areas outlined above as the focal points in need of improving in order to achieve a better functioning commercial legal environment for national and foreign investors, importers, and exporters. "Best practices" based on the experience of other countries could play an important role for the introduction of innovative approaches to solve specific problems. In some countries in Europe, for example, judges are selected on the basis of merit; in some other countries, such as the U.S., local communities vote judges into office. The common use of case precedence in arriving at final decisions, a practice used in countries under a common law justice system, should be proposed for wide use under the Salvadoran legal system.
24. Specific proposals to be explored and developed would include:
  - enactment of a new law for judicial career development;
  - separation of the education of judges from that of lawyers;
  - requiring the selection of candidates for judges be based on results of written and oral exams and standing in the ranking of final exams at graduation;
  - a comprehensive law (and revision of the Constitution) that regulates all major aspects of the judicial career from preparation of judges to accountability of performing judges;

- freeing up Supreme Court justices from many time-consuming administrative matters and transferring such responsibility to the CNJ;
  - creation of a citizens' oversight board to review the procedures and decisions in the selection process of justices and judges and recommend reform designed to minimize political influences on the selection process;
  - introduction of reforms aimed at reducing political influence on the administration of justice and instead strengthening the independence and accountability of judges; and
  - strengthening the observance of precedence in the decision-making process of justices and judges.
25. The above areas deserve consideration in the formulation of a new program aimed at improving the administration of justice. In selecting new programs and projects, duplication should be avoided of existing programs being carried out by the Inter-American Development Bank (IDB), USAID (*Proyecto PAS*), or other organizations (outlined in Appendix II). Furthermore, new programs should be confined to addressing weaknesses in the administration of justice affecting the commercial environment.

## 2.2 Dispute Settlement/Arbitration Centers

26. **The Problem: Privately operated arbitration centers, a positive step for dispute resolution, need technical assistance toward the establishment of structural and enforcement guidelines.**
27. As mentioned above, the poor application of commercial laws and the business sector's inability to achieve fair and expeditious dispute resolution adversely affects El Salvador's economic environment. Companies can face substantial business losses if the courts do not enforce contract terms. Recently, in response to failing investor confidence in the justice system and after several years of efforts by the private sector, an Arbitration Law<sup>2</sup> was passed to allow universities, professional associations, and private sector organizations to set up arbitration centers specifically designed to address the problems associated with dispute settlement. The first arbitration center is to be created and operated by the Salvadoran Chamber of Commerce and Industry under an agreement with the IDB.
28. The national and foreign private sector, particularly the Chamber, has high hopes that one or more such centers will be able to introduce a high degree of fairness to dispute settlements. Resort to arbitration will be voluntary, but the decisions will be binding. There is to be no government involvement in the arbitration process, but the Ministry of Governance will have the authority to approve the creation of a center or to disband it. Implementing regulations for the centers are to be published within two months.
29. The requirements to approve the arbitration center are simple. Interested parties must prepare a feasibility study and demonstrate that they have sufficient logistical, administrative, and financial ability to operate the center. Additionally, the interested parties must present a description of the bylaws, a code of ethics for the center, and details regarding how the decisions made by the arbitrators will be filed and recorded. As part of the bylaws, the interested parties will be required to present a list of arbitrators (not less than 20), the requirements for becoming an arbitrator, the method for appointing an arbitrator, the period during which the list of arbitrators will be effective, and the motives for dismissing an arbitrator. The bylaws will also state the center's fees,

<sup>2</sup> Legislative Decree Number 914 of July 11, 2002, published in the Official Gazette No. 153 of August 21, 2002.

organizational structure, and procedural rules governing the arbitration process. The Chamber of Commerce has already started to invite lawyers to apply for inclusion on an approved list.

30. The two parties in a dispute will each have the right to select one arbitrator either from the list of arbitrators authorized by the center or from outside that list, but each party will have the right to reject the nomination from the other party. Each will have to find an arbitrator acceptable to the other party in the dispute. The two arbitrators that are selected will then jointly agree on the nomination of a third arbitrator. Resolution will presumably require only a majority of two rather than unanimity. A decision will be binding and will be enforced by court action following the same rules applicable to judicial decisions elsewhere, and all remedies will be available to the interested parties.
31. **The Recommendation: A high-priority, near-term project to establish clear guidelines for the effective functioning of the arbitration centers and for the speedy enforcement of decisions and awards.**
32. Urgency and high priority should be applied to efforts to ensure that the implementing regulations outline an effective path for a fair and impartial process to dispute resolution. Clear guidelines should be established for effective functioning of the centers. Impartial, skilled arbitrators familiar with all relevant legislation should become available. Enforcement of the decision by the arbitrators should be carried out effectively and speedily within a prescribed time frame by judges. If it works, it could serve as an example that reform is possible for the slow and poorly functioning court system.

## 2.3 Labor Regulations

33. **The Problem: El Salvador never ratified signed ILO agreements to establish and implement laws governing labor union formation and collective bargaining.**
34. Deficient labor laws in El Salvador and lax implementation result in unfair labor cost advantages for Salvadoran firms when in competition against importers or when operating in foreign markets where labor rights are fully observed. In other words, failure to protect labor rights translates into unfair competition that reduces the opportunities created by trade liberalization for foreign exporters to compete in El Salvador's market, while unfairly enhancing the competitiveness of Salvadoran exports.
35. Article 47<sup>3</sup> of El Salvador's Constitution provides for the right to form labor unions freely in the private sector and in state-owned companies. The Constitution also guarantees collective bargaining. These provisions, though in the Labor Code,<sup>4</sup> have not been enforced effectively to adequately protect workers from unfair practices by their employers. Some national companies and foreign investors resort to illegal practices to prevent unionization and collective bargaining in their companies. Although it is a crime punishable by the Criminal Code with a penalty of one to three

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<sup>3</sup> Article 47: Employers and workers in the private sector, without distinction of nationality, sex, race, religion, or political ideology, or the nature of the work they perform, have the right of association for the defense of their respective interests and of forming professional associations or unions. Workers of state-owned companies have the same rights. Such organizations have the right to be officially chartered and to be protected in the performance of their functions. Dissolution or suspension can only be ordered according to the formalities determined by law.

<sup>4</sup> The constitutional provisions are developed by the Labor Code in several sections and articles. For reference, please refer to Articles 2, 30 #5, 204, 205, 208, 218, and 219.

years in prison to coerce a worker not to become a member of a labor union,<sup>5</sup> punishment for such an action has seldom been carried out. That, of course, encourages other violations of worker rights.

36. Recourse by workers to the courts often takes too long and is too costly for workers to pursue. Moreover, judges often do not follow the procedures established by the law and they are influenced by outside pressures, thus making the legal procedures non-transparent and their final judgment highly uncertain. A worker can take his case to the Ministry of Labor for faster processing. Although the Ministry can declare an employer guilty, it has no juridical means of enforcing justice, such as collecting fines or jailing the guilty.
37. In 1949, the ILO issued two agreements with its member countries, including El Salvador, that commit the governments to implement and enforce the freedom to form unions and legislation for unimpeded collective bargaining. Neither of the two agreements was ever ratified by El Salvador's National Assembly. The reason later given by the government was that changes in the Constitution would be required in order to allow unionization and collective bargaining for government employees. (Changes in the Constitution require passage by two consecutive legislatures.) In fact, however, the Constitution only prohibits public employees from striking, not unionizing, but the government seems to conclude that unions are synonymous with strikes.
38. El Salvador is considered in violation of labor rights according to ILO rules. A formal alignment with ILO rules is likely to be required in CAFTA to protect labor rights and fair competition standards.
39. **The Recommendation: A high-priority, near-term project to prepare proposals for a new law or for the reform of existing labor legislation containing the elements originally negotiated with the ILO, plus provisions strengthening the enforcement of the new legislation on the freedom to form unions and to engage in collective bargaining.**
40. There is now a clear priority for El Salvador to conclude and ratify such agreements signed with the ILO, because ratification or at least a commitment to do so is likely to be required in CAFTA. A detailed review may be necessary of the system, methods, and institutions in place for monitoring and enforcement of compliance with the provisions in the Labor Code. Workers have generally limited resources to maintain themselves and their families for any length of time without earnings. Cases of abuse of workers' rights brought before the Ministry of Labor should be processed expeditiously in one simple process (not in two), and judgments, remedies, or penalties must be automatically applied by court action. Currently, a worker takes his grievance first to the Ministry of Labor for remedial action. If the employer, however, refuses to comply or to reach a settlement, the Ministry has no legal power to enforce its decision. As a result, the worker has to drop his case or to take it to a labor court for prosecution.

## 2.4 Revision of the Commercial Code's Agency Law

### 2.4.1 The Commercial Code

41. The Commercial Code is the most comprehensive law that articulates the basic principles, parameters, and details regulating the organization and conduct of all commercial businesses in El

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<sup>5</sup> Article 247 of the Criminal Code: "Any person who impedes or limits another person of the right to form a union or the right to strike will be sanctioned with imprisonment of one to three years."

Salvador. It includes not only the registrations and incorporation of all businesses, but also regulates aspects of insurance, lending, financial instruments and securities, some transportation matters, conditions for contract termination, and other governance issues. It is the key element regulating the commercial legal environment, thereby impacting positively or negatively commercial activity and private investments. The Commercial Code was revised and then passed, together with a new Investment Law, in October 1999. It was implemented in April 2000.

42. A “Review of the Commercial Code,” submitted to USAID/El Salvador by DevTech Systems in July 2000, concluded that, “the Commercial Code appears not to be a serious impediment to economic growth in El Salvador.” While the revamped Code was a clear improvement over the old one, particularly in terms of reducing red tape burdensome to the private sector, it was later felt that further revisions were necessary. By June 2002, a comprehensive, elaborate set of revisions, sponsored by the IDB, was completed as the *Proyecto del Nuevo Código de Comercio* by the Washington, DC-based Center for the Economic Analysis of Law.
43. Private sector organizations and others are currently proposing revisions. Most likely, the revisions will be coordinated by the Supreme Court in conjunction with the *Unidad Técnica de Evaluación* (UTE), a unit within the Ministry of Governance that is mainly in charge of drafting the proposed legislation. Currently, the draft is being analyzed by the Civil Chamber of the Supreme Court that will soon decide what the next step should be in the review process. Most likely, discussion of the draft will take place by the legal community, business organizations, and other stakeholders. As this is a comprehensive piece of legislation, many discussions will be held over a long period of time before the final draft bill is submitted for approval by the Assembly.

## 2.4.2 The Agency Law

44. **The Problem: The Agency Law’s required indemnity payments to agents or distributors with lapsed or terminated contracts can prove excessive.**
45. The provisions in the Commercial Code relating to contracts with agents or distributors, such as the Agency Law’s sometimes excessive indemnity payments, are likely to be obstacles for attracting some foreign companies to invest in or to export to El Salvador. The objective of the Agency Law is to protect small agents or distributors with little or no bargaining power from arbitrary, unfair treatment by large, powerful companies.
46. Article 397 of the Commercial Code states that in cases where the supplier firm wishes to terminate its contract with an agent or distributor of its products or to let the contract term expire, the law requires payment of an indemnity to the agent or distributor. The size of the indemnity can be exorbitant and a serious drain on the profits of the supplier firm. The indemnity is calculated, according to the Commercial Code, by including the agent’s last three years of gross revenue (in this case, calculated as gross sales less cost of goods sold); the value of the investments made by the agent in inventory, installations, equipment, and other investments related to the conduct of his business; and the value of credits granted by the agent to third parties for merchandise sold. This provision of the law applies across the board to cases large or small.
47. The indemnity payoff is considered excessive in some cases. The law can thus act as a significant obstacle to attracting foreign investors who can take their business to an environment where they do not encounter the potential threat of multi-million dollar indemnity payments. This law, applied indiscriminately, can provide an incentive for abuse, because an agent or distributor may find ways to collect the indemnity if he himself wants to end the business relationship. Currently, there is a



case in court involving a distributor of Chrysler trailers whose contract has lapsed and now he demands an indemnity of nearly \$3 million under the provisions of the Code.

48. U.S. oil marketing companies fear they could face indemnity claims of similar size by individual gasoline retailers for letting a contract lapse after its term expires. This would depend on whether a judge would accord gasoline station operators the status of “distributor” rather than that of contractor. In a previous case, the Supreme Court rejected this interpretation. This law could impact investors in other activities and prove to be particularly onerous in cases involving sizable annual sales and large investments. A law that provides for excessive indemnity payments to agents and distributors will act as a deterrent for foreign investors and exporters, particularly in association with a high level of insecurity about the outcome of disputes under the Salvadoran justice system.
49. **The Recommendation: A high-priority, near-term project to develop options for a more equitable approach, including the removal of this provision in a revised Commercial Code, calculation of indemnity payments on the basis of net profits, or limiting payments or eligibility.**
50. Reform of the provisions in the Commercial Code applying to indemnities for contract lapses with agents should be considered near-term and high-priority, because these provisions can act as an obstacle to attract new foreign investments and trade to take advantage of new opportunities created by CAFTA.
51. Options should be developed for improving the fairness of this law or to abolish it altogether. Guatemala abolished its onerous Agency Law in 1998 by a decree (*Decreto* No. 8-98), citing in the law the need to comply with WTO commitments. Abolishment of the Agency Law apparently had no adverse consequences. An agent can be expected to act in his self-interest by negotiating conditions for contract termination and indemnity payments that are fair. If the supplier firm then breaks any of the agreed contract terms, the agent should have the right to take court action to seek a fair and prompt remedy. Letting the agreed term of a contract expire without renewing it should be an option for both parties without automatically invoking penalty (indemnity) payments against one of the parties.
52. Other proposed revisions of the Commercial Code to be developed include setting an upper cap for indemnity payments, more narrowly defining the eligibility for receiving indemnity payments, changing the calculation on the basis of the net profits of the agent rather than gross revenue, or differentiating between large and small distributors in the calculation of the indemnity. The fairness and likely impact on the investment climate of each option should be examined.
53. Whatever the preferred option, it should include clearly defined rules when an indemnity is to be paid, as well as just cause for contract termination that will not require indemnity payments.

## 2.5 Technical Assistance for the Office of the Administration of Treaties

54. **The Problem: The Office of the Administration of Treaties (OAT), with little experience in monitoring rules of origin, could present problems for complying with the terms of CAFTA.**
55. The two-year-old operation of El Salvador’s OAT appears to have insufficient experience in effectively monitoring and testing complex products in world trade to determine reliably the origin

of the products and enforcing compliance with the rules of origin established in a future CAFTA. According to private sector sources, the OAT is inadequately staffed (with only 10 people) and budgeted, lacking trained experts. The manager of the OAT disagrees, however. He claims his staff has gained sufficient experience in administering the new free trade agreement with Mexico to be able to cope with the expected requirements of a future CAFTA. The free trade treaty with the U.S., however, will be broader and more complex than the agreement with Mexico.

56. If the OAT does not work efficiently and reliably, it will cause a variety of potential problems for U.S. exporters, Salvadoran importers, and U.S. counterpart treaty administrators. These problems include wrong or unfair conclusions and judgments acting on complaints about unfair competition, dumping practices, violations of the rules of origin, or even wrong product classification for duty assessment.
57. The activities of the OAT will be confined to the trade component of CAFTA, that is, trade in products and, later, trade in services. The OAT is set up to act on initiatives from importers requesting that the phased reductions of a particular duty be accelerated. The focus, however, will be on following up complaints of unfair competitive practices in trade, including product dumping or violation of the rules of origin by U.S. companies.
58. The administration of the rules of origin under the treaty will be based on an “honor system” of accepting on good faith the declaration of the origin of the products on the invoice. Entry of the shipment will be permitted on this basis. If there is cause for doubt, then a product sample will be tested by the OAT. Importers of agricultural, sanitary, and other health products will be advised to contact the Ministry of Agriculture or Health, respectively, to obtain entry certification where they may be required to have their product undergo a lab test. If the OAT determines that a violation of the rules of origin has occurred, it notifies customs, who is empowered to impose a duty and possibly a penalty.
59. Under CAFTA, the OAT will keep track of the agreed tariff reductions over time and determine the prevailing tariff rate for a given product at the time of entry of a shipment and then notify customs of the tariff rate to use in calculating and assessing the duty amount to be paid. The OAT manager expects the greatest difficulties in administering the trade provisions of CAFTA to be at customs, where inspection procedures, port congestion, and transport problems will cause delays and other problems.
60. **The Recommendation: A high-priority, short-term project to develop an effective training program for employees of the OAT in monitoring, testing, and enforcing compliance with the rules of origin that will govern CAFTA.**
61. The current organizational structure of the OAT should be studied, and changes recommended in order to arrive at an efficient, reliable operation. Aside from an employee technical training program, the OAT could be divided into specialized subsections, each dealing with separate aspects of the administration of treaties. Suggested subdivisions include sections for:
  - legal interpretation and implementation of the treaty provisions,
  - administering the rules of origin of products,
  - dumping and safeguard provisions in the free trade agreements,
  - treaty provisions relating to service sectors, and
  - monitoring path of declining tariff rates agreed in the treaties and advising Customs of the correct tariff rates to apply for incoming shipments.



62. After an appropriate organization has been determined, then the required staffing and budget could be calculated.

## 3.0 High-Priority, Longer-Term Recommendations

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### 3.1 Harmonization of Laws and Regulations within the Central American Common Market

63. **The Problem: The harmonization of laws, regulations, and their application under a Central American Common Market (CACM) has not advanced enough to avoid problems in fully implementing CAFTA.**
64. Regional integration toward the establishment of a full-fledged, unified CACM, as originally envisioned when it was first conceived in the 1960s, is likely to receive a new impetus as a result of the negotiation leading up to the implementation of CAFTA. The member countries will find impediments to the full realization of future benefits under CAFTA if they do not progress with the creation of a single CACM. These impediments are mostly in the legal and regulatory environment.
65. In recent months, customs regulations and sanitary and product registration have been harmonized. Registration to sell a product in one country is now, in theory, automatically accepted in the other Common Market countries. Agreement has been reached to adopt a uniform value-added tax by 2004, probably at 15%. These harmonized regulations, however, are not being fully implemented, and most other regulations continue to be implemented differently in each country. Each of the five Central American countries still maintain independent regulations relating to:
- import duties and customs procedures,
  - product specifications and registration,
  - labeling and product description,
  - information requirements, sanitary standards and testing,
  - licensing and permit systems, and
  - tax and subsidy regimes.
66. Because the above have not been harmonized in the Common Market, it will greatly complicate compliance with uniform provisions in CAFTA, and the U.S. will not conclude a separate free trade agreement with each Central American country. Under the present circumstances, it will be difficult for all five countries to accept one uniform set of terms and conditions under the treaty and then try to make their diverse regulations conform to these uniform requirements.
67. To fully implement uniform provisions and commitments in CAFTA, further integration and harmonization of the legal and regulatory environment throughout the region will become necessary in the above areas listed. Harmonization of laws and regulations will probably be needed in additional areas, such as labor regulations; anti-monopoly legislation; government procurement procedures; compliance with WTO rules; and a common, uniform external import tariff regime against products from third countries.
68. **The Recommendation: A high-priority, longer-term regional Central American project to promote public-private sector working groups to analyze regulatory and institutional diversities and develop programs for harmonization.**

69. Plans and work programs should be developed for the formation and the tasks of public-private sector working groups composed of representatives from each Central American country to analyze defined regulatory and institutional diversities and develop and recommend programs for regional harmonization. Working groups could focus on regional regulatory harmonization by specific economic sectors or by topics. Success in advancing regional harmonization of the regulatory environment for business would advance economic integration, expand free trade, and improve efficiencies of doing business throughout Central America. The initiatives of the working groups would be strongly supported by local business associations as well as foreign investors.
70. Some of this type of work has been done, but mostly among governments with or without input from private sector groups. The local and foreign private sector would play a more effective role in the regulatory harmonization process if regional public-private sector partnerships could be formed that would jointly formulate proposals for harmonizing the regulatory environment for business. This could also have an ancillary benefit of removing excessive red tape and redundant regulations and restrictions where they still prevail.

### 3.2 Anti-Monopoly Legislation

71. **The Problem: The absence of an anti-monopoly law encourages monopolistic practices and other noncompetitive behavior, and the Salvadoran government lacks the political will to propose and pass such legislation.**
72. El Salvador does not have effective legislation prohibiting monopolistic practices that restrict imports and competition. As a result, benefits from trade liberalization and free trade agreements are reduced, because opportunities for importers are being unfairly and illegally restricted. There are no efforts to monitor or identify monopolistic practices, no injunctions, and no cases before the courts. Monopolies or quasi-monopolies operate in a number of sectors in El Salvador's small market, some even under government protection. An example of this is the only rice producer in the country who enjoys the benefits of government regulation that prohibits any rice imports until all domestically produced rice has been sold. In the sugar sector, one company controls all distribution, sales, and domestic market price in disregard of the Constitution and the Commercial Code. These practices continue and are even protected by the government because neither the Constitution nor the Commercial Code clearly define illegal monopolistic practices. There are currently no penalties for abusive monopolistic practices.
73. The Constitution<sup>6</sup> only permits companies managed by the state or the municipalities to engage in monopolistic practices. The Constitution prohibits monopolistic behavior by private companies that restrict competition, and the Commercial Code<sup>7</sup> disallows unfair competition. These remedies are insufficient as they permit many appeals and the process normally takes years to reach conclusion. A comprehensive anti-monopoly law is therefore needed with implementing regulations defining illegal monopolistic practices and specifying a speedy process, enforcement, regulation, and penalties.

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<sup>6</sup> Article 110 of the Constitution: "A monopoly cannot be authorized except for the State or the Municipalities when the social interest is served..." "To guarantee the free enterprise and protection of the consumer, monopolistic practices are prohibited..."

<sup>7</sup> Article 491 of the Commercial Code defines unfair competition, and Articles 492 to 497 specify the actions affected parties can take. Operating licenses can be revoked for companies and people engaged in these practices, pursuant to Articles 422 (i).

74. During the past five years, several anti-monopoly bills were introduced and discussed in the Assembly. Anti-monopoly legislation has been strongly supported by NGOs usually identified with the political left, but local business interests have managed to prevent passage of any of these proposed bills. The Ministry of Economy has no plans to introduce a government-backed anti-monopoly bill, yet the objectives of CAFTA will be compromised by the absence of such a bill. As the Salvadoran market is opening to imports, some Salvadoran producers will resort to protecting their local market against imports by concluding exclusive arrangements with local distributors that prohibit or limit imports of competing products.
75. **The Recommendation: A high-priority, longer-term project to review past anti-monopoly bills and revive and support the one that best protects against monopolistic abuses.**
76. An examination of past draft legislation shows that all bills would prohibit monopolistic practices that limit competition, and would set up a standalone, regulatory entity to monitor and oversee company behavior in the market place. The proposed bills also call for an anti-monopoly law separate from the Commercial Code.
77. The prospect of CAFTA should now provide renewed energy toward the passing of anti-monopoly legislation. Without it, some U.S. exporters will face barriers to entry and, conversely, Salvadoran importers will not be able to realize new opportunities offered by the free trade agreement. After examining the various anti-monopoly bills that were introduced in the past, efforts should be made to revive the one that best ensures effective enforcement against abusive monopolistic practices.
78. Proposals for an anti-monopoly initiative should focus on two parallel aspects:
- legislation that clearly defines all aspects of abusive and market-restrictive monopolistic behavior, outlaws such behavior, provides for specific penalties, and offers guidelines for judges to follow when prosecuting a case; and
  - the creation of a regulatory body, independent of the private sector, with adequate financial resources and staffing, capable of identifying and charging companies with specific violations of the anti-monopoly law.
79. A new anti-monopoly law should not target any specific sector as the government recently attempted to do within a proposed hydrocarbon law. The law should apply to monopolistic behavior in any private sector.

### 3.3 Labor Code

80. **The Problem: Regulations in the Labor Code are considered too inflexible by the private sector.**
81. While labor legislation is currently inadequately enforced to meet the standards of the ILO and CAFTA, the Salvadoran investment promotion office, PROESA, reports that the strict and detailed provisions in the Labor Code are obstacles to attracting some foreign investments. The Labor Code is considered too confining to attract investors to set up call centers and other investments in labor intensive service sectors that require flexibility in work hours, regular overtime work, part-time work, and nighttime work. The Labor Code is not flexible with these types of work, as it imposes a

doubling of hourly wages for overtime and requires special approvals or additional fringe benefits.<sup>8</sup> A worker has the right for an indemnity equivalent to one month's basic wage for each year worked when released from employment.<sup>9</sup>

82. **The Recommendation: A high-priority, longer-term project to review the Labor Code and propose more flexible provisions for attracting investments in labor-intensive service sectors.**

83. Making the Labor Code more flexible in some areas would help attract more foreign investment in labor-intensive service sectors where El Salvador may have good prospects of attracting more investments. Such an initiative should be considered of high priority for El Salvador, although it may take time to get these reform proposals agreed upon and approved by the government and the Assembly.

### 3.4 World Trade Organization Compliance

84. **The Problem: Tax incentives for companies in Free Trade Zones are considered in violation of WTO rules (compliance to be completed by 2010).**

85. As member of the WTO, El Salvador has agreed to comply with the rules of that organization. Under the Agreement on Trade-Related Investment Measures (TRIMs) and the Agreement on Subsidies and Countervail Measures, incentives are deemed to be subsidies that distort trade and hence violate WTO rules if they are granted conditional upon export performance or the use of domestic goods or domestic value-added inputs (except wages and cost of local services). A number of countries, including El Salvador, have applied for and been granted until 2007 to start complying with these rules. They must complete the process by 2010.

86. Tax incentives offered to companies located in the Free Trade Zones are considered in violation of WTO rules because the incentives are based on export performance. The tax benefits offered to companies in Free Trade Zones would comply with WTO rules if these benefits were to be offered also on sales from the Free Trade Zones into the domestic market under the same condition as for export sales by these companies. A tax rebate of 6% offered to companies outside the Free Trade Zone that export only part of their production may comply with WTO rules because this incentive is not applied exclusively to export sales or profits.

87. CAFTA and later the FTAA are very likely to require that WTO rules be observed by participating countries, including El Salvador. The extension granted by the WTO for compliance is likely to be honored under these free trade agreements, but this is not certain at this time.

88. **The Recommendation: A high-priority, longer-term project to develop for El Salvador, preferably together with other Central American and Caribbean countries, legal entities and strategies for ameliorating or overcoming the double-negative effects of WTO noncompliance**

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<sup>8</sup> Article 25 of the Labor Code has a very restrictive definition for “temporary workers.” If the Article’s conditions are not met (in practice, they are very difficult to meet), workers are considered permanent employees, no matter what the stated terms and special conditions are in the worker’s contract. This situation has negative consequences for employers. For “permanent workers,” the law requires employers to pay annual vacations, bonuses, etc., and these are subject to specific authorizations and compensation rules, according to Articles 168, 169, and 170.

<sup>9</sup> Article 58: When a permanent employee is released without cause, the employer must pay severance equivalent to one month’s basic salary for each year worked. The indemnity cannot be less than the equivalent of a 15-day salary. The definition of salary for these calculations has a special limit in the law: “it shall not be larger than four times the legal, minimum base salary in effect.”

**and termination of the Multi-Fiber Agreement on El Salvador's and Central America's largest and most dynamic export sector.**

89. It is urgent that El Salvador, preferably together with the other affected Central American countries, develop strategies to deal with the double-negative effects of WTO compliance and scheduled termination of the Multi-fiber Agreement on their largest export sector, the *maquiladora* industries in the Free Trade Zones. An existing or a new institution, preferably as a public-private partnership, should be organized and staffed for this effort.
90. Strategies and programs should be developed both for the survival of the textile export industry and for intensification of export diversification. Aggressive promotion activity abroad should be targeted to attract companies to El Salvador that produce exports of textiles designed for upscale and niche markets where quality and design is emphasized over price and volume. Producers should be encouraged to move from value-added to “full package” production and to increasingly seek cheaper E-commerce purchasing of inputs. A concomitant effort should be made to diversify future export development (discussed further in Appendix I).<sup>10</sup>

## **4.0 Lower-Priority, Longer-Term Recommendations**

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### **4.1 Intellectual Property Rights Protection**

91. **The Problem: Lax enforcement of IPR laws.**
92. Lax judicial enforcement of Intellectual Property Rights (IPR) laws continues to be a negative factor in the business environment. This manifests itself in continued compact disc (CD) and software piracy, and other violations that often go unpunished. Despite police raids against IPR piracy, failure in the application of the laws by the courts to protect IPR effectively causes millions of dollars of lost sales and profits in El Salvador for the victimized companies, according to estimates by the International Intellectual Property Alliance.
93. According to the Criminal Procedural Code,<sup>11</sup> charges must be filed in a formal complaint before the Attorney General's office can take action. These charges have to be made by the owners of the CDs or software. The law requires proof that the owners of the intellectual property have suffered damages by the violation. A distributor or importer of the CDs is not considered an owner of the intellectual property. Violators thus often find ways to avoid court action or escape fines or other forms of punishment. In one case, a judge dismissed charges on the grounds that it could not be proven that the owner who filed the charges was the actual owner of the intellectual property of Michael Jackson music. According to one business source, it can take up to five years to resolve a case of trademark violation.
94. There is a wide gap between the existing IPR laws and their implementation and enforcement that affect the business environment negatively. Notable advances have been made in all areas of IPR

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<sup>10</sup> Any efforts or activities in this area to be financed by USAID must comply with, and be conducted in accordance with, Chapter 225 of USAID's Automated Directives System which is entitled “Program Principles for Trade and Investment Activities and the ‘Impact of U.S. Jobs’ and ‘Workers’ Rights’” and any applicable legal restrictions on USAID funding.

<sup>11</sup> Article 26 of the Criminal Procedural Code provides that prosecution of crimes committed against intellectual property or industrial property requires a formal complaint by the affected parties.

legislation toward full compliance with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) on trademarks, copyrights, and patents.

95. **The Recommendation: A lower-priority, longer-term project to continue work on proposals for active monitoring programs and improved enforcement of compliance and prosecution.**
96. Effective judicial enforcement of IPR laws should focus on broadening the definition of ownership to IPR to include also those who market IPR-protected products. Judicial steps toward a final, irrevocable judgment must be simplified and shortened; judges must follow established, transparent judicial procedures and publicly justify their decisions; and the imposition and enforcement of decreed remedies or penalties must be swift. These reforms will probably have to be part of the broader reforms needed in the application of the rule of law. Another consideration is to change the law to allow the Attorney General's Office to proactively identify and bring charges against violators of IPR rather than wait for formal charges to be filed. Though the political will is lacking to accord high priority to these needed reforms on effective IPR protection, this issue could well gain significance under CAFTA. Continued work on proposals and programs for improved monitoring and enforcement of compliance and prosecution is recommended.

## 4.2 The Government Procurement Law

97. In general, a sound government procurement law should provide for national, non-discriminatory, transparent treatment of all technically eligible bidders. Information about future public tenders should be publicized adequately and early so that all interested potential bidders can prepare to meet all requirements for the bid. Clear rules need to govern the bidding and selection process by impartial bid administrators. A losing bidder should have the right and opportunity to challenge the outcome of a bid before an independent judicial authority.
98. El Salvador's new Government Procurement Law of January 2001 is an improvement over the old law in all respects. It provides for national, non-discriminatory, transparent treatment, reducing opportunities for corrupt practices. Nonetheless, there are deficiencies in the new law that can effectively exclude foreign companies from bidding for government contracts.
99. The new law covers a broad range of government activities, including:
- concessions,
  - public works contracts,
  - consulting services,
  - leasing of equipment, and
  - purchases of supplies.
100. A new department, the *Unidad Normativa de Adquisiciones y Contrataciones de la Administración Pública* (UNAC), was created under the Ministry of Finance to design and supervise the government purchase and contracting policy and enforce the Government Procurement Law and its implementing regulations. Under the direction of UNAC, every government agency organizes its own purchasing and contracting unit, the *Unidad de Adquisiciones y Contrataciones Institucional* (UACI), responsible for preparing, carrying out, and awarding bids for purchases and contracts requested by ministries and departments. UACIs pre-qualify local and foreign companies for bidding and keep a databank about interested bidders. The conditions and procedures for bids are outlined in Article 44 of the Law.



101. Depending on the magnitude of the bid, a UACI may pre-announce the bid offer not only in local, but also in specialized international publications. A reasonable amount of time, depending on the complexity of the project (but not less than 10 working days), has to be given to firms to prepare and submit their bids. If only two bids are submitted, the tender is declared invalid and a new one ordered. Losing bidders have a right to request a review of the procedures of the bid resolution, according to the procedures outlined in Article 77 of the Law. The official who issued the resolution has 15 working days to act on the request. As a last resort, the affected bidder can take his case for review by the justice system.
102. **The Problem: The new law restricts “emergency” tenders with inadequate prior notice, and it excludes bids and concessions for natural resource exploitation or existing infrastructure projects, requiring a special law in each case.**
103. The new law greatly restricts the cases when an “emergency” can be invoked to issue a tender without adequate prior notice. In practice, however, the “emergency” clause is still often used and private sector sources complain that corrupt practices continue to be quite common in government procurements. Bids need to be publicized well in advance for international companies to bid. In practice, that is often not done. Appeals even to the courts do not result in justice. Some private sector sources claim that the most frequent corrupt acts committed revolve around government procurement bids. PROBIDAD, a small, registered NGO that fights corrupt practices, and *Controlaria Social*, the body that oversees procurement procedures, have started to hold public hearings to apply pressure for more transparency in the public sector bid system. PROBIDAD and some local lawyers argue that fairness is not being observed in the new law by according national treatment to financially strong foreign companies when bidding against financially weaker national companies.
104. Where concessions are concerned, the new law applies to only new infrastructure projects. A very important shortcoming of the new law is that it does not include bids for concessions to manage, operate, or invest in existing infrastructure sectors (ports, airports, transportation), mining, petroleum, and other natural resource areas, which must be developed under separate, special laws. These are large, capital-intensive sectors, such as the port of Acajutla, where government procurement bids are normally standard procedure and where efficient, technically advanced, and financially strong bidders are needed. These projects are required by Article 120 of the Constitution to be governed by special laws to be passed by the Assembly for each individual project and hence not governed by any across-the-board commitment to apply standardized bid procedures, transparency of the bid and award process, and national treatment of foreign investors.
105. **The Recommendation: A lower-priority, longer-term project to eliminate the abuse of “emergency” tenders and explicitly extend the rules for transparent, non-discriminatory, national treatment of bidders to concessions for natural resource and all infrastructure development.**
106. All qualified bidders should be protected from discrimination, exclusion, or other arbitrary acts. The practice of allowing “emergency” bids without adequate prior notice should be disallowed altogether, except for small government tenders, such as sundry office supplies. The law would conform to internationally accepted standards and provisions in the North Atlantic Free Trade Agreement (NAFTA) and the U.S.-Chile Free Trade Agreement. This issue gains further significance in view of the need for large government spending to modernize infrastructure to overcome the country’s serious transportation disadvantages and bottlenecks for efficient low-cost foreign trade. This issue is further developed in Appendix I.

### 4.3 National Treatment

107. **The Problem: The Constitution and the Investment Law reserve economic sectors for national and CACM micro and small enterprises, but provision is not currently enforced.**
108. National treatment of foreign investment is protected by the laws and mostly well observed in practice. The telecommunication law excludes foreign investment only in radio and TV broadcasting. Disputes have recently arisen between groups or individual foreign investors and the government or a powerful local company, but a clear case for discrimination cannot be made.
109. The Constitution supports national treatment for foreign investment, except in the case of small enterprises. Article 115<sup>12</sup> states that the micro and small company sectors “are the patrimony of Salvadoran and Central American investors.” This provision implies that micro and small enterprises should be protected by the government and such protection could, in extreme cases, lead to excluding foreign companies in specific sectors in order to help Salvadoran companies survive. Such exclusion has not occurred and small foreign enterprises are operating without restrictions. This provision, nonetheless, creates uncertainty for small foreign investors, particularly in service sectors, that a future politically inspired campaign could start applying pressure on the Assembly and the government to pass a law that would enforce this provision of the constitution. The threat of a future enforcement of this provision in the constitution would probably increase if a shift in political power were to occur in government or the Assembly. (The ARENA/PCN coalition still holds a majority of seats in the Assembly.)
110. **The Recommendation: A lower priority, longer-term project to develop a proposal for legislation aimed at unequivocally extending national treatment to all foreign investors in conformance with international standards and obligations. The Constitution may have to be amended to conform to such a broader application of national treatment.**
111. It may be politically difficult to arrive at an amendment of the Constitution on this issue, as such amendments require a vote and approval by two consecutive Assemblies. Yet it may be necessary in conjunction with approval of a secondary law that would meet WTO and CAFTA standards by establishing national treatment for all foreign investors, large and small.

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<sup>12</sup> Article 115: “Commercial, industrial, and service activities performed by small companies are the patrimony of Salvadorans by birth and those born in Central America. The protection, promotion, and development of such small companies will be subject to a law.”



## APPENDIX I: Economic Impediments to the Growth of El Salvador's Trade and Investment

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112. In discussions with representatives from El Salvador's private sector associations and with individual national and foreign investors, it became clear that many considered obstacles of an economic nature to be more serious bottlenecks for the development of trade and foreign investment than the weak elements in the commercial legal environment.
113. El Salvador now has the most open economy in Central America, and its democracy, political stability, economic reform, free market policies, institutional strengthening have advanced substantially in recent years. However, obstacles to future trade and investment growth remain. These include:
- The inflow of foreign investment and the growth of nontraditional exports have been disappointing, except for the *maquiladora* sector.
  - To fully benefit from CAFTA, transportation sectors and the export and investment promotion effort in particular will need to be improved.
  - An end to the Multi-Fiber Agreement in 2005 and the Free Trade Zone tax incentives (not WTO compliant) by 2010 could greatly diminish El Salvador's principal export sector. Plans for restructuring the *maquiladora* sector and other sectors of the economy urgently need to be devised.

### Transportation

114. **The Problem: High transport costs and bottlenecks will limit be benefits from CAFTA.**
115. Because of its geographical location with no Atlantic ports, El Salvador is at a distinct transport disadvantage vis-à-vis the other Central American countries in trade with the U.S., particularly since most of that trade traditionally has been through U.S. Atlantic and Gulf coast ports, particularly Miami. Added to the geographical disadvantage are other major impediments that further increase the cost of moving goods to and from U.S. markets and thus reduce the competitiveness of Salvadoran products and the interest of U.S. companies to invest in El Salvador.
116. Acajutla, El Salvador's main port, is congested, inefficient, and costly to use. The physical conditions around the port severely limit expansion to achieve greater efficiency. The oil companies are not affected because they offload outside the port by means of undersea pipelines leading directly to their onshore oil tanks. Some modernization of the port is being planned. A major development of a second port is underway in the south on the Gulf of Fonseca near the Honduran border. The cost of moving goods through the port of Acajutla is said to be the highest in Central America, not only due to loading and unloading delays, but also because CEPA, the port authority, charges the highest port fees in Central America. Ships carrying goods entering or leaving the port of Acajutla pay the Panama Canal toll when passing through the canal to the U.S. East Coast ports.
117. El Salvador's road and railroad systems are said to be in disrepair, adding to overland transport costs. Nonetheless, a good part of El Salvador's trade with the U.S. passes overland across Guatemala or Honduras and through their ports. Companies report discriminatory treatment in the loading of Salvadoran products at these ports by often loading first the country's own products while Salvadoran products have to wait in the port. Goods entering from the U.S. for El Salvador

are sometimes held up for days and up to a week even at customs at the border with Guatemala due to prolonged, detailed inspections, invoice verifications, or minor irregularities in filling out forms.

118. According to private sector sources, these transport problems have been a major factor in impairing the competitiveness of Salvadoran exports and contributing to the relatively low growth rate of nontraditional exports, except those from the Free Trade Zones.
119. **The Recommendation: Initiate a comprehensive study of all transport problems associated with foreign trade and develop a national plan for removing transport bottlenecks and attracting national and foreign private investors to help rehabilitate major roads and railroads.**
120. Following “best practices” in other countries, long-term management contracts, concessions, and incentives could be offered private investors.

## Free Trade Zones and the Maquiladora Sector

121. **The Problem: El Salvador’s most dynamic export sector will suffer decline instead of growth under CAFTA as world quotas for textiles are lifted with the end of the Multi-Fiber Agreement and tax incentives in Free Trade Zones are phased out under WTO rules.**
122. As outlined earlier in this report, these double threats are real, but they would negatively affect the textile sector in all Central American and Caribbean countries. In a world free market for textiles, caused by the end of the quota system under the Multi-Fiber Agreement, investors in these small countries could not compete against textile products from China, India, and other very low-wage Asian countries with the advantages of very large internal markets and economies of scale. Losses in export markets would cause the closure of *maquiladora* operations in the Free Trade Zones because the companies could no longer take advantage of the tax incentives even if the WTO were to change its position and allow such incentives to continue.
123. **The Recommendation: It is urgent to develop strategies to deal with these approaching negative factors for Salvadoran exports. Joint Central American efforts should look to preserving preferential access to the U.S. market for the textile industry and to countering the Asian competitive threat to the profitability of the textile exporters. Textile companies should be encouraged to shift from value-added to “full package,” integrated production; use more low-cost, E-commerce purchasing sources; and organize to supply upscale, niche markets where quality and design are more important than price and volume.**
124. Greater efforts should be undertaken over the short term to further advance regional integration, particularly by completing the creation of a truly single Central American market. It would then have economies of scale large enough for broadening the capacity to attract a wide range of foreign investment that would accelerate export growth and diversification.

## Investment and Export Promotion

125. **The Problem: El Salvador will have to be far more successful with investment and export promotion in order to overcome its geographical, transportation, and foreign exchange disadvantages to fully benefit from CAFTA. Otherwise, foreign investors will prefer to locate their investments for servicing the U.S. market in other Central American countries.**

126. Investment and promotion efforts have not been particularly successful in El Salvador compared to Costa Rica, the Dominican Republic, and some other Latin American countries. Conscious of the importance of these activities for the development of El Salvador, the government has created new institutions with the sole responsibility of promoting and facilitating investments. A new export promotion agency is also to be created. This may not be enough.
127. **The Recommendation: Emphasize focused, aggressive investment promotion abroad, and look into the possibilities for a Private Investment Center.**
128. Consideration should be given to focus on aggressive, targeted investment promotion abroad instead of relying only on a Web site, networking, or trade fairs to bring foreign investors to El Salvador. Personnel at the promotion office should have private sector experience and be specifically trained for proactive, targeted investment promotion activity abroad. The promotion agency should be organized to identify foreign companies that could most likely be attracted to El Salvador, given the new opportunities created by CAFTA. Personnel from the promotion agency should contact the management of a company and create an opportunity for a professional presentation analyzing the factors particularly suitable in El Salvador for the company to have an interest in investing there. Subsequent follow-up should be designed to heighten the company's interest in pursuing this possibility further. This approach should be done again with individual companies. Getting three or four companies to invest in El Salvador should provide enough benefits for the economy in terms of jobs, incomes, tax revenue, production, and exports to offset the annual cost of the promotion effort. Staff in PROESA should be trained for assuming a proactive investment promotion role as outlined above, and COEXPORT should use a similar approach for export development, unless these entities were to be merged into a Private Investment Center.<sup>13</sup>
129. Currently, the investment promotion office reports to the Vice President, the “one-stop shop” for investors reports to the Minister of Economy, and the export promotion office to the private sector. Separating these interrelated promotion agencies and placing them in different institutions may not have produced the best results, partly because the Vice President, the Minister of Economy, and private sector associations are too busy with other responsibilities to give the promotion efforts the attention they deserve. To underscore the fundamental importance for El Salvador to achieve success in stimulating more private investment, consideration could be given to combining all of the promotion functions as separate departments in one entity, a Private Investment Center (PIC), possibly including a Trade and Investment Information Office and database. The head of the PIC could report to one Minister or the Vice President, or perhaps could be given Cabinet rank to report directly to the President. Thus elevating investment promotion activities would underscore importance for the creation of jobs, incomes, and government revenue.
130. The advancement of the general manager of the PIC to Cabinet rank would enable him to assume final authority and responsibility for investment and export promotion. He would have an advocacy interest and the authority to push for reforms, also in the legal and regulatory area, to enhance the prospects of his success in attracting more private investments. He could translate feedback from private investors into reform proposals designed to improve the business climate throughout El Salvador.

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<sup>13</sup> See footnote #10 on page 16.

## APPENDIX II: Donor-Funded Programs

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### I. Programa para el Apoyo al Sistema de Justicia

131. PAS-DPK Consulting, funded by USAID. The project focuses on four different areas:
- Training for officials exercising judiciary power (judges, prosecutors, arbitrators, etc.). The funding is granted to the *Consejo Nacional de la Judicatura* (CNJ). Training programs are run by the *Escuela de Capacitación Judicial*.
  - Training for judges, prosecutors, and public defenders in the techniques used in oral judicial proceedings. Such updating is needed, since proceedings in El Salvador have been changing from written to oral. There has also been a discussion and study to propose new legal procedures. The discussion was held by Kary Converse with judges, prosecutors and public defenders.
  - Training to prepare judges, prosecutors, and public defenders for the practice of penal law. This course, developed with participation from the *Policía Nacional Civil* (PNC), relates to techniques of investigation.
  - Development of a program for mediation, conciliation and negotiation activities to be performed by the *Procuraduría General de la República* (PGR).

### II. Fortalecimiento de la Capacitación Inicial y Continua de Operadores Jurídicos

132. Funded by *Agencia Española de Cooperación Internacional*. Foreign consultants will be hired to train operators in both substantive and procedural law in penal, civil, and trade areas. The training program includes such subjects as applications for judges, Justices of the Peace, appeal courts, public prosecutors, Supreme Court justices, and *Unidad Técnica de Evaluación*. The program is developed and performed specifically for officials involved with administration of justice on all levels.

### III. Programa de Reforma Judicial II

133. Funded by the IDB and administered by the UTE. The project is divided in two areas:
- Technical assistance for training of applicants for judges in penal (alternative penalties to imprisonment) and mediation (judicial and administrative) areas.
  - Donation for book acquisitions to the CNJ library and for several publications of penal and crime law.

### IV. Programa de Fortalecimiento Institucional de los Entes Reguladores del Sector Financiero

134. Funded by the IDB. This is a multi-annual project developed by the *Escuela de Capacitación Judicial* of the CNJ. The program's purpose is to implement a one-year training course for judges, prosecutors, and arbitrators. The training course covers the main areas of commercial law (not only trade matters, but also areas related to penal and administrative sanctions and penalties). In the first year, foreign presenters will offer the course to applicants. They will also prepare Salvadorans to

take over future courses. Even if the project is scheduled for only a four-year term, the *Escuela de Capacitación Judicial* intends to continue it after the expiration of its term.

## V. Modernización de la Legislación Comercial

135. Administered by the UTE. This project is divided into three areas:

- Development of a new Commercial Code. This project has been developed over the last few years, but is not currently funded. On the other hand, IDB is financing a review of the “*Ley de Procedimientos Mercantiles*” (commercial procedural law) being done by UTE.
- The IDB is also financing a “Nuevo Código Procesal Civil” (new civil procedural code).
- The IDB’s Multilateral Investment Fund (MIF) is financing a project by UTE and the *Cámara de Comercio de El Salvador* (Chamber of Commerce) to create and operate an Arbitration Center.

## VI. Proyecto de Apoyo a la Reforma del Sistema de Justicia

136. Funded by IDB (US\$27.3 million). The four main activities are:

- Creation of several new offices (in Santa Ana, San Miguel and San Salvador) of the *Instituto Salvadoreño para el Desarrollo Integral de la Niñez y la Adolescencia* (Childhood Protection Office).
- Purchase of new computer software and hardware for the offices of the Supreme Court, public prosecutor, *Ministerio de Gobernación* and *Procuraduría General de la República* (Attorney General).
- Monitoring the Supreme Court’s activities.
- New office buildings for the Supreme Court and the *Procuraduría General de la República*.

137. The CNJ and the *Escuela de Capacitación Judicial* have divided between themselves the training of applicants for justices and judges (of all types). Applicants for judges are trained in the *Programas de Formación Inicial*, while judges (in different areas) are trained in the *Programas de Capacitación Continua*. This division was made in order to provide adequate training to justices and judges in all areas of the justice system, according to their capabilities, preparation, and duties.

138. Currently, all funds from the different entities (IDB/MIF, USAID, *Cooperación Española*, etc.) to the CNJ are administered by the United Nations Development Program.

## APPENDIX III: Salvadoran Laws and Codes Consulted

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*Anteproyecto de Ley Anti-Monopolio*  
*Anteproyecto modificación a la ley de creación de la Superintendencia General de Electricidad (SIGET)*  
*Código Civil*  
*Código de Comercio*  
*Código de Trabajo*  
*Código Penal*  
*Código Procesal Civil*  
*Código Procesal Penal*  
*Código Tributario*  
*Constitución de la República de El Salvador*  
*Convenio de la OIT C87*  
*Convenio de la OIT C98*  
*GATT (1994)*  
*Ley de adquisiciones y contrataciones de la Administración Pública (Procurement Law)*  
*Ley de Bancos y Financieras*  
*Ley de fomento y protección de la propiedad intelectual*  
*Ley de Impuesto a la transferencia de bienes muebles y a la prestación de servicios (IVA)*  
*Ley de Impuesto sobre la renta*  
*Ley de Inversiones*  
*Ley Orgánica de la Dirección General de Impuestos Internos*  
*Ley de Procedimientos Mercantiles*  
*Ley de Protección al Consumidor*  
*Ley de la Carrera Judicial*  
*Ley de la Dirección Nacional de Registros (Centro Nacional de Registros)*  
*Ley de la Superintendencia de Sociedades y Empresas Mercantiles*  
*Ley General de Aduanas*  
*Ley Orgánica de la Dirección General de Impuestos Internos*  
*Protocolo de Tegucigalpa a la Carta de la Organización de Estados Centroamericanos (ODECA)*  
*Reglamento de la Ley de Fomento y Protección de la Propiedad Intelectual*  
*WTO Agreement on Subsidies and Countervail Measures*  
*WTO Agreement on TRIMs*  
*WTO Agreement on TRIPs*

## APPENDIX IV: Local and U.S. Contacts Interviewed

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### Contacts in San Salvador

Aleman Gurdian, Juan Daniel, CEO, Sigma S. A.

Andino, Mario, President, FUNDAPYME

Alfaro Araujo, Roger, Director of Negotiations, *Banco Multisectorial de Inversiones*

Arce, Carlos E., Manager of Business Development, Office of Economic Growth and Education, USAID

Artiga, Belisario Amadeo, Attorney General (*Fiscalia General de la Republica*)

Beltranena, Beatriz, Vice President, Citibank/El Salvador

Bettaglio, Enzo, Executive Director, American Chamber of Commerce

Candray, Antonio, Executive Director, CENTRA – *Centro de Estudios Laborales*

Castro Kreutz, Ricardo, Senior Vice President, Latin American Operations, PriceSmart, Inc.

Cobarruviaz, Luis A., Program Manager, ICITAP – International Investigative Training Assistance Program, U.S.Embassy

Cornick, Tully, Sub-Director, U.S. Embassy

Cuellar Sicilia, Silvia M., Executive Director, COEXPORT

d'Aubuisson, Ricardo Esmahan, Executive Director, CAMARGO – Agro-industrial Chamber

Greenberg, Ronald, Director, Office of Economic Growth and Education, USAID

Guandique Mejia, Luis Ernesto, Lawyer, Guandique, Segovia, Quintanilla

Guatemala, Alvaro Ernesto, Executive Director, FUSADES

Hernández Pena, Oscar, Director, Office for Commerce and Investment, Government of El Salvador

Herrera Coello, Mauricio, Project Manager, Democracy and Governance Office, USAID

Herrera, Miguel Fabio, Agricultural Specialist, Office for Agriculture, U.S. Embassy

Imberton Deneke, Carlos, General Manager, C. Imberton

Interian, Mauricio, General Manager, Microsoft/El Salvador

Kury de Mendoza, Lissette, President, CNJ

Magana, Jose Mario, Director, Chamber of Commerce and Industry

Martinez, Julia Evelin, Director, FUNDAPYME

Mata, Ricardo, Manager of Operations, C. Imberton

Membreno, Luis, Director, American Chamber of Commerce of El Salvador

Mendoza, Pedro Alejandro, Legal Advisor, ANEP

Milian Jerez, Alfredo, Executive Coordinator, Commission of Textile Quotas, FUNDATEX

O'Donnell, Madalene T., USAID

Orellana Merlos, Carlos, Section Chief, Department of Economic and Social Studies, FUSADES

Padilla Aquino, Jose Alberto, Executive Director, Chamber of Commerce and Industry

Peralta Avalos, Beatriz, Executive Director, PROESA

Rivas Boschma, Federico, Assistant General Manager, Texaco Caribbean Inc.

Rivera, Manuel, General Manager, ExxonMobil/El Salvador



Rodríguez Villamil, Danilo, Lawyer, Espino Nieto, Umana & Associates  
Romero Pineda, Roberto, President, Romero Pineda & Associates  
Rooney, Matthew M., Economic and Commercial Counselor, U.S. Embassy

Safie M., Mauricio R., General Manager, HM Electronics, Inc.  
Salazar, Rene, Executive Director, OAT  
Salume Artinano, Adolfo, President, PEPSI/El Salvador  
Sandoval, Rommell Ismael, Assistant Director, Project PAS, DPK Consulting  
Schechter, Julie, Assistant Counselor for Political Affairs, U.S. Embassy  
Segovia, Luis Nelson, Lawyer, Guandique, Segovia, Quintanilla

Tinetti, Jose Albino, Profesor, Superior College for Economy and Business  
Tomasino, Jose E., Partner, Delgado & Cevallos

Velasco Zelaya, Mauricio, Magistrate of the Supreme Court  
Villacorta, Guillermo, IDB

## **Contacts in Washington and Miami**

Bastian, Walter M., Deputy Assistant Secretary for the Western Hemisphere, U.S. Department of Commerce, Washington, DC

Cira, Carl A., Director, Summit of the Americas Center, Florida International University, Miami  
Cohen, Calman J., President, Emergency Committee for American Trade, Washington, DC  
Corte, Maria C., Director, Trade & Transportation Programs, Caribbean Latin American *Actino*, Washington, DC

Fernandez-Sivori, Alfredo, Public Affairs Manager, Caribbean and Central America, ExxonMobil, Miami

Leon, Rene A., Ambassador of El Salvador, Washington, DC  
Lewis, David E., Vice President, Manchester Trade Ltd., Washington, DC

Menghetti, Linda, Vice President, Emergency Committee for American Trade, Washington, DC

Romero, Werner, Counselor for Economic Affairs, Embassy of El Salvador

Sacasa, Federico, President, Caribbean Latin American Action